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Hard Landing

"The deficit country is absorbing more, taking consumption and investment together, than its own production. In this sense, it is drawing on foreign savings. In return it has to pay interest or profit to the lenders. Whether this is a good bargain or not depends upon the nature of the use to which the funds are put. If they merely permit an excess of consumption over production, the economy is on the road to ruin."

Collected Economic Papers, Vol. IV
Joan Robinson, 1973

Once again, blind euphoria reigns on Wall Street. As we predicted in our last letter, signs of a slowing U.S. economy have sparked rallies in both bonds and stocks. Buoyed by soothing words from Federal Reserve Chairman Alan Greenspan, the Dow even has pushed through the much-heralded 4000 mark.

Don't be fooled: This rally is as dangerous as it is absurd. The global liquidity crunch unleashed in 1994 by the Fed's initial interest-rate hikes is far from over. Around the world, the big debtor and big deficit countries are in serious trouble. The United States is no exception. A dollar crisis looms, perhaps the worst ever.

For now, Wall Street ignores these ominous trends, preferring to focus on its own bullish fantasies. Chief among these: a soaring hope that the U.S. economy will touch down in a perfect "soft landing," as growth slows painlessly to the 2.5% annual rate thought consistent with low inflation. This miracle is expected to usher in a renewed golden age of low inflation, low and falling interest rates and steady gains in corporate profits.

We hate to spoil the party, but the facts are unavoidable. In our view, the U.S economy is on course for a hard, not a soft landing. This shouldn't come as a surprise: The current expansion is the most ill-formed ever, dependent as never before on a debt-financed consumption binge, and an accompanying surge in business inventories.

This simply cannot last. U.S. household balance sheets have been ravaged by declining liquidity and by 1994's sharp decline in financial asset values. Already, higher rates are starting to brake consumer spending. We think the deceleration will be surprisingly abrupt, ending in recession later this year.

The dollar will bear the brunt of any hard landing. Even now, a growing sense that the Fed is finished raising rates is fueling a massive flight away from the short-term, dollar-denominated bank deposits that largely have financed the huge U.S. current-account deficits of recent years. The DM is now the safe haven of choice – in line with our long-standing recommendations.

How will the Fed respond to the approaching crisis? Raising rates to defend the dollar would shatter the nascent U.S. bond and stock rallies, triggering another vicious, downward turn in global liquidity. This in itself would undermine the dollar, and worsen the increasingly desperate situation in Mexico.

Failing to defend the dollar, however, could trigger a complete stampede away from the U.S. currency. Such a collapse would be catastrophic for the world economy, and for global financial markets. For the United States, it easily could turn a hard landing into a crash landing.

THE FLIGHT TO QUALITY

The new year has started with a bang in the currency markets. The continuing global liquidity crunch has put upward pressure on the Deutsche mark, not just against the ERM currencies, but also against the dollar and even the yen. The unsettled political climate in Spain and Italy is widely blamed for sharp declines in the lira and the peseta to new record lows against the DM. In addition, uncertainties about the upcoming French presidential elections, the fate of British prime minister John Major, and Sweden's budget woes all are seen contributing to weakness in the French franc, the British pound and the Swedish krona, respectively.

But as we noted in last month's letter, those who profess to find a disparate cause for each new currency disaster are simply deluding themselves. There is in fact only one crisis, and it is the crisis of the big debtor countries. The continuing contraction of global capital flows, triggered by the collapse of the bond bubble of the early 1990s, has left their currencies vulnerable to the debilitating effects of their yawning current-account deficits.

This is most clearly seen in Mexico, where a U.S.-led rescue effort so far has failed to stabilize either the peso or the Mexican markets. As we predicted in our last letter, the resources involved have proven far too meager to have the desired effect on investor confidence. Indeed, the terms and conditions of the U.S. aid package almost certainly will make matters worse.

By requiring the Bank of Mexico to viciously squeeze the domestic money supply, U.S. officials hope to relieve the pressure on the peso, avoiding an expensive, sustained intervention effort – a campaign that would quickly exhaust the limited supply of dollars available to support it.

But such a brutal contraction of liquidity will crush Mexico's banking system, as well as the vast number of private speculators who leveraged themselves in both pesos and dollars. Such a systemic financial failure is hardly likely to prove reassuring to foreign investors. Inevitably, the peso will plunge.

The horns of the dilemma couldn't be more clear: By defending the peso, the Bank of Mexico risks a collapse of the peso. In the end, we think, only a massive injection of peso *and* dollar liquidity can save Mexico from a meltdown every bit as bad, if not worse, than in 1982. Such a debacle would quickly drag down the other Latin American countries, in particular Argentina, with its dollar-based reserve system. The dollar-bloc countries of Southeast Asia also would suffer. All this can have nothing but negative effects on the U.S. currency.

Indeed, the primary, crucial issue now for the currency markets – and for world economies – is the fate of the dollar. Just like at this same time last year, bullish forecasts abound on Wall Street. Even the growing threat posed by the Mexican crisis has not blunted this enthusiasm.

Will those optimistic forecasts prove more accurate this year? We have taken a close look at the evidence and are not convinced. In fact, we would argue that the forces now threatening the dollar differ only in degree, not in kind, from those crushing the Mexican peso.

All forecasts of a rising dollar hinge on two chief assumptions. One is that the U.S. economy will continue to forge ahead, forcing the Federal Reserve into further monetary tightenings to head off inflationary pressures. A sharp widening of the spread between U.S. rates, on the one hand, and German and Japanese rates, on the other, is supposed to propel a cyclical rally in the dollar over the next six to twelve months.

The most recent precedents for such a scenario are the dollar's sharp rises in 1983-84 and 1988-89. But a careful comparison of today's monetary and economic conditions with those past periods of dollar bullishness has only deepened our pessimism.

Global Capital Market Trends

Equities

Selected Markets, % Change

Country (February 24)	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia	2.6%	-0.8%	-13.0%	-13.0%	4.8%
Canada	1.0%	-5.6%	-4.8%	-10.6%	4.0%
France	1.4%	-4.0%	-18.2%	-20.0%	1.9%
Germany	5.0%	0.6%	1.4%	-6.7%	8.1%
Hong Kong	17.0%	0.3%	-21.2%	-21.2%	18.0%
Japan	-3.3%	-11.4%	-11.6%	-18.9%	0.0%
Mexico	-25.9%	-34.6%	-40.1%	-45.6%	0.0%
Spain	2.1%	-1.2%	-17.8%	-19.3%	3.2%
U.K.	2.3%	-0.9%	-7.0%	-8.7%	5.6%
U.S.	4.8%	6.3%	5.2%	0.0%	11.2%

Ten-Year Bond Yields

Selected Markets, Basis Point Change

Country (February 24)	Current Rate(%)	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia	10.15	-35	11	307	-56	307
Canada	8.77	-76	-37	173	-91	180
France	8.01	-17	-26	187	-42	187
Germany	7.41	-15	-21	131	-35	133
Japan	4.42	-26	-15	38	54	53
Spain	11.74	-25	-10	327	-38	327
U.K.	8.66	-6	-5	161	-37	176
U.S.	7.31	-54	-51	110	-71	118

Exchange Rates

Versus U.S. Dollar, % Change

Country (February 24)	Current Rate	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia ($)	1.35	-3.7%	-4.4%	2.2%	-4.7%	5.6%
Canada ($)	1.39	1.8%	0.9%	-3.0%	-3.7%	2.4%
France (FF)	5.15	1.7%	3.6%	11.8%	-1.0%	12.4%
Germany (DM)	1.46	3.3%	5.8%	15.1%	0.0%	15.1%
Japan (Yen)	96.9	2.8%	2.7%	7.7%	-0.3%	8.8%
Spain (Pta)	128.8	2.3%	2.1%	7.6%	-3.9%	8.8%
U.K. (Sterling)	1.59	-0.6%	1.5%	7.0%	-3.0%	8.5%

As with the other big debtor countries, the key secular force driving the dollar down is the huge, chronic U.S. current-account deficit. But in trying to assess the near-term trend of the dollar, we must distinguish between this primary force and the lesser, cyclical factors that can lead to short and medium-run fluctuations.

Looking back at recent history, we note that in 1988-89, the dollar rose against the DM from a low of 1.56 marks in early 1988 to a high of 2.04 marks in June 1989. The dollar also rose from 120 yen to 150 yen during roughly that same period.

But in drawing comparisons with the present-day situation, we would note three crucial differences:

- From 1987 to 1989, the U.S. current-account deficit narrowed from $167.3 billion to $101.6 billion, as the U.S. export sector recovered from the extremely overvalued dollar of the early 1980s. From 1992 to 1994, on the other hand, the U.S. deficit deteriorated from roughly $67 billion to nearly $170 billion.
- During 1988 and 1989, U.S. short-term interest rates hovered about 400 basis points over equivalent DM rates. Currently, the spread is only 100-150 basis points. In 1989, the federal funds rate reached 9.75%, or approximately 4.5% in real terms. This time, the Fed took almost a year to raise it to 6%, or about 3% in real terms.
- A third crucial difference concerns the pattern of U.S. economic growth. In 1988-89, the expansion was export-led, reflecting a truly tight U.S. monetary policy. The current recovery is consumption-led, reflecting rampant internal credit creation.

Our conclusion: The traditional cyclical forces that should be working in the dollar's favor simply are not strong enough to overcome the severe structural weaknesses engendered by the widening U.S. current-account deficit. We shall discuss these trends in more detail below, but the implications should be obvious. All the elements are in place for a classic dollar crisis. We would argue that such a crisis is the greatest threat now facing the world economy and the financial markets.

Yet when the Fed hiked rates by another 50 basis points on February 1, most commentators focused on just one question: Would it be enough to restrain the economy? Many expressed their doubts and predicted further rate hikes.

For investors, we think it more relevant to consider the possible or probable implications of higher U.S. short-term rates for international currency and other financial markets. Would they be helped or harmed? The dollar's fate depends on the answer to that question.

We readily admit that, like many others, we have grossly underestimated the vigor of the U.S. economic recovery. We had expected the sharp spike in U.S. bond yields would drastically curb consumer borrowing by killing off the mortgage refinancing boom, leading to a sharp economic deceleration.

We were half right. Higher yields did kill off the refi boom. But they did not stop the borrowing rampage by U.S. consumers, who simply shifted to an unprecedented use of auto and credit-card debt. In tandem with strong job and income growth, consumer-installment credit soared at its fastest pace ever through most of 1994. No less than 40% of the increase in consumer spending last year was financed by borrowing, a new secular high.

U.S. CONSUMERS ARE TAPPED OUT

While this turn of events took us by surprise, we continue to believe the current consumer borrowing and spending binge is unsustainable. In our eyes, it inevitably will end in a sudden weakening. While there is no way to predict the timing of this downturn, recent data from the Fed, showing consumer-installment debt growth falling in December to a 9.8% annualized rate – from almost 17% in November – could signal the turning point.

What is more, U.S. household balance sheets now are in the worst shape of the entire postwar period. Debt levels are at an all-time high relative to income. The ratio of liquid bank deposits to total household debt has fallen by half over the past decade, reflecting a massive shift by consumers into illiquid bond and equity mutual funds. As a result, declining bond and stock prices have deeply eroded financial wealth.

Indeed, the total losses suffered by private savers and investors in bonds, stocks and derivatives over the past year add up to many hundreds of billions of dollars. Yet market sentiment remains strangely bullish. The main underlying reason, obviously, is the widespread conviction that the U.S. economy is in excellent fundamental shape and is heading for a painless "soft landing."

The soft-landing scenario, widely propagated by Wall Street, implies a slowdown of the economy to an annual growth rate of 2.5%, in line with its long-term, noninflationary potential. Once this rate is reached – the argument goes – it can be sustained over a prolonged period, perhaps for the rest of the decade.

With this happy ending for the economy and inflation will come an equally happy ending for the financial markets. As inflation fears abate, bond and stock markets both are supposed to embark on a big and sustained rally.

We suspect this general belief in the soft-landing scenario has played a crucial role in fostering a general complacency about the huge losses incurred by investors over the past year. Having been convinced by Wall Street gurus and their disciples in the media that the next big rally is just around the corner, most investors and speculators still refuse to take their losses and run.

It also seems to us that many frustrated investors are drawing hope from the leading stock indexes, such as the Dow and the S&P 500, which have rallied to new highs in recent weeks on growing hopes for the soft-landing scenario. But these gains only mask broader market weakness, as seen in the dramatic price declines incurred by the "average" stocks in those same indexes, especially when compared to their individual 52-week highs.

Consider the following: Through November 30, 1994, the S&P 500 declined 5.9% from its peak earlier in the year. But the average decline in the stocks in the index from their individual 52-week highs was a much more substantial 18.8%.

Of a sample of 7,351 actively-traded stocks, over 83% were down more than 10% from their peaks. Almost 60% lost more than 20%. Nearly 40% were down 30% or more.

That the indexes themselves nevertheless have managed to rally in recent weeks is a clear sign of the drastic deterioration in market breadth over the past year – a direct consequence of the worsening liquidity squeeze. Still, we suppose most investors won't recognize what actually is happening in the market until the major stock indexes themselves finally succumb to steep declines.

We describe this situation in some detail in order to challenge the still prevailing, general complacency – a mood that only has been heightened in recent weeks by the signs of a slowing U.S. economy.

In all modesty, we may claim that our bearish forecasts about the financial markets and the dollar have been vindicated by developments in 1994. But what about 1995? To be frank, we view 1994 as a transition phase from bull market to bear market. The great bull market that started in 1982 is not dying easily. Nevertheless, it's definitely expiring. That remains our steadfast conviction.

What makes us so sure the long-term bull market in bonds and stocks finally has turned into a primary, prolonged bear market? It is the only conclusion we can draw from our careful analysis of the trends in money growth, and our equally thorough review of the supply of global savings in relation to the actual and potential flow of funds into the financial markets.

As we always have stressed, the various bear markets of 1994 had one common connection: a progressive U.S. liquidity and capital crunch. The watershed event for global bond markets came on February 4, 1994, when the U.S. Federal Reserve raised short-term rates for the first time in four years. Though a modest move, it instantly set off a global bond crash.

As we have pointed out so many times, the causes of any crash always can be found in the speculative orgy that preceded it. In this vein, the ongoing global liquidity crunch we are now experiencing originated in the Fed's preceding, super-easy monetary stance. Between 1991 and 1994, abysmally low short-term interest rates, fostered by the Federal Reserve, spawned a rampant flight from bank deposits into bond and stock mutual funds, massive yield-curve speculation, an unprecedented mortgage-refinancing boom, and a frantic move by U.S. investors into higher-yielding international bourses.

NO SCRAMBLE FOR LIQUIDITY – YET

We said earlier that we regarded 1994 as a transition year in the move from a bull market to long-term bear market. Last year was marked by a drastic slowdown in the flow of funds into the financial markets, but not by an outright reversal of those flows, which would have implied heavy selling of stocks and bonds and a general rush for liquidity by investors.

Recent weeks have even seen a revival of the frenzy of yield-curve playing that helped fuel the bond bubble of the early 1990s. Hoping that the Fed's last rate hike will prove to have been the last for this economic cycle, more daring speculators have returned to the profitable game of borrowing at short-term rates in the repo market in order to buy longer-term Treasuries. This has driven the yield on the two-year note down quite sharply from the highs it hit in early January.

This counter-trend rally cannot last. The broader flows of funds that fueled the bond bubble – such as the massive shift by small savers out of bank deposits and into bond mutual funds – continue to slow. Ultimately, this will lead to a resumption of the bear market in bonds, perhaps in conjunction with the dollar crisis now looming on the horizon.

Funds Raised in U.S. Credit and Equity Markets

In billions of dollars

Year	Total	Total Credit	Government Securities	Corporate & Foreign Bonds	Mortgages & Consumer Credit	Other Credit	Mutual Funds	Corporate Equities
1982	547	530	226	52	109	143	9	8
1983	738	692	253	47	237	145	29	27
1984	888	933	272	88	304	259	27	-73
1985	1167	1143	326	143	344	330	89	-65
1986	1286	1191	395	223	353	210	161	-66
1987	1046	1033	316	165	369	183	70	-57
1988	922	1019	275	162	350	232	6	-103
1989	904	964	296	120	327	221	37	-98
1990	882	862	414	115	216	117	65	-46
1991	858	642	424	160	147	-89	152	64
1992	1091	795	460	160	130	45	212	84
1993	1398	961	417	253	222	69	317	120
1993 Q1	1045	701	410	251	122	-82	269	75
Q2	1431	959	393	213	195	158	358	114
Q3	1633	1135	461	300	305	69	349	149
Q4	1484	1050	406	247	265	132	292	142
1994 Q1	1276	1062	551	213	225	73	114	101
Q2	1055	836	368	110	285	73	153	66
Q3	1072	955	359	97	347	152	131	-14

Source: Federal Reserve

The table above illustrates the dramatic ups and downs in the various components of the flows that fueled the U.S. financial boom of the early 1990s. And it tracks the subsequent sharp slowdown in those flows since late 1993. We draw attention to the fact that the tide actually crested in third quarter 1993, coinciding precisely with the cresting of the boom in U.S. bonds – well before the Fed undertook its first rate hike.

Between 1990 and that 1993 turning point, total flows of funds into U.S. credit and equity markets virtually doubled, from $882 billion to $1,638 billion, at annualized rates. Within this total, flows into bond and stock mutual funds more than quintupled to $350 billion.

How to assess this tremendous rise in the flow of funds into the financial markets? The decisive criterion is the gap between available domestic savings and total flows into credit and investment. The difference between the two constitutes monetary inflation, that is to say, money creation and/or an increase in money velocity as buyers of stocks and bonds draw on their existing money balances.

Available U.S. business and personal savings amounted to a mere $290 billion in 1993 and $330 billion in the third quarter of 1994, annualized. This makes for a ludicrous disparity between the total supply of savings and the total flow of funds.

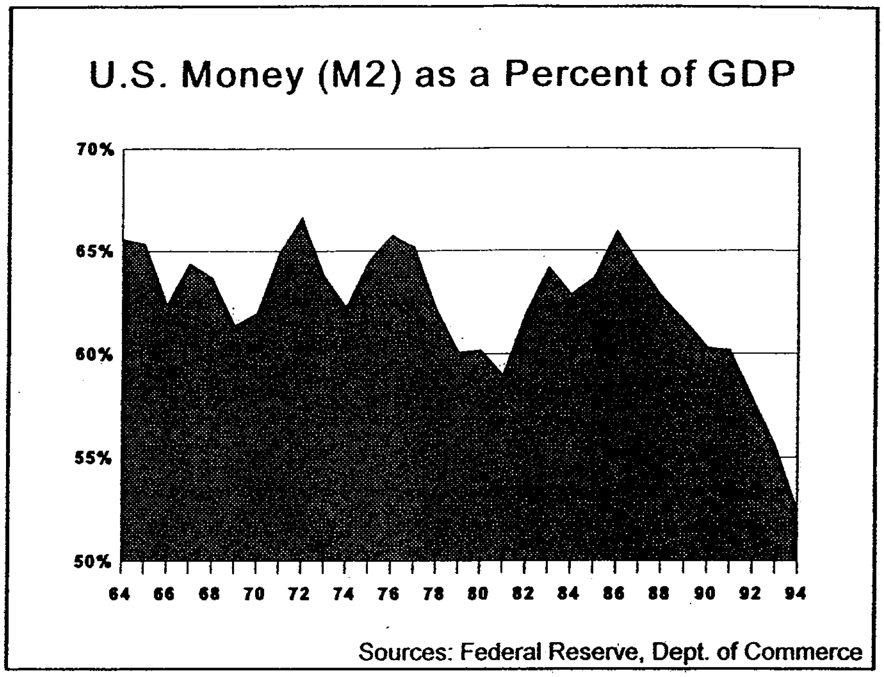
The important thing to see is the drastic deceleration in the flow of funds since the third quarter of 1993. But relative to current savings, these flows remain grossly excessive. This really is the key source of our bearishness for the U.S. financial markets, both bonds and stocks.

In past letters, in particularly the October 1994 issue, we have explained in detail how this virtual money deluge, which flooded the U.S. and global financial markets during 1990-93, came into being, and how it could happen at a time of virtually zero broad U.S. money growth.

We've pointed to two main reasons for this development:

- An unprecedented surge in debt leveraging outside the banking system.

- A "dash from cash," as investors fled low-yielding bank deposits.



Both money flows had in common the fact that they left the money stock unchanged. What the boom reflected was not excess liquidity but rather a flight from liquidity into illiquid assets.

Our conclusion – and our warning – was that the booming U.S. financial markets of the early 1990s had created a mirage of excess liquidity, while in reality liquidity was in a disastrous downtrend, as measured by broad money aggregates.

While everybody spoke of excess liquidity fueling the boom, we pointed out that in the United States the ratio of money to GDP or national income has been in a steep decline since 1987. And it's getting worse, not better. During the past three months, U.S. M1 and M2 both have contracted. M2, as a percent of GDP, has hit a record low of 52.5%.

Broad money – representing mainly bank deposits – is the measurable part of overall liquidity. Another, more important part escapes any measuring. That's the liquidity of asset markets, meaning the possibility of buying and selling assets without causing undue changes in their prices. According to reports we get, the recent relative stability of the global bond markets is masking a dramatic deterioration in market liquidity. With activity in the bond markets concentrated in futures, cash trading remains very thin.

Frankly speaking, we are at a complete loss to see how this global investment logjam can unwind itself, considering the huge borrowing requirements of governments in the industrial countries, on the one hand, and the dismal liquidity and savings trends, on the other. In the end, further steep price declines are inevitable.

THE DUBIOUS CASE FOR THE DOLLAR

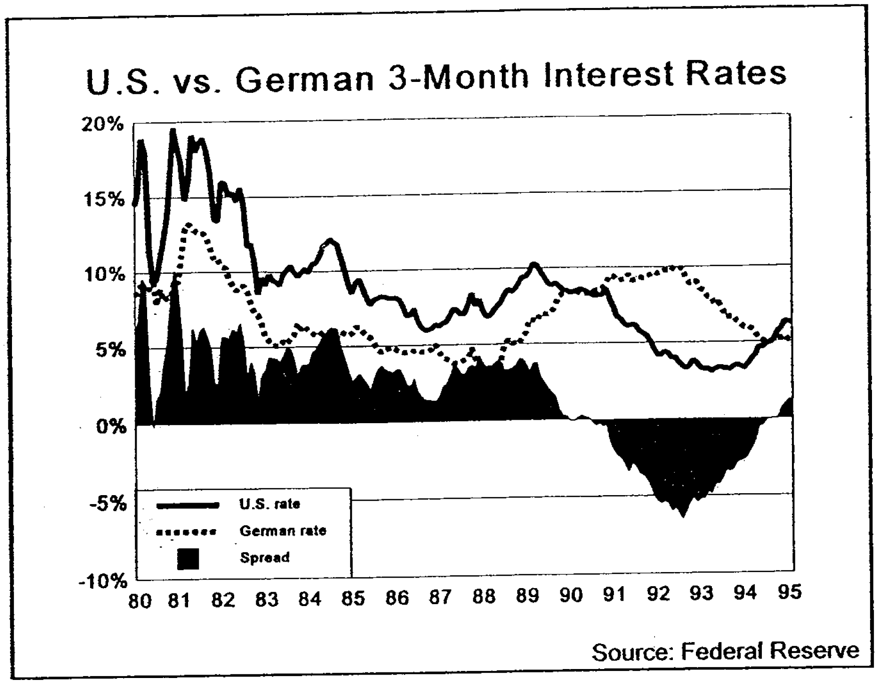
A renewed decline in U.S. stock and bond prices would spell disaster for the dollar. Already, the bulls have been dismayed by the total failure of the dollar to hold on to its modest gains of late November and December, despite the continuing rise in U.S. short-term interest rates. Mexico's peso crisis gets much of the blame.

We believe far deeper forces are at work undermining the dollar. For a start, we think Wall Street's dollar bulls place far too much emphasis on the curative powers of short-term interest rates. Rising U.S. short-term rates didn't help the dollar for much of 1994. But the generally accepted view is that the Fed's recent moves – its 75-basis point tightening in November and its 50-basis point move February 1 – have made the crucial difference in enhancing the U.S. central bank's anti-inflation credibility.

We have a number of problems with this new version of the old dollar bull story. It begins with the basic idea that changes in interest-rate differentials are a reliable, major factor in determining dollar strength or weakness against the

DM and the yen. Yet during the 1980s, U.S. short-term rates generally were 2-4% above their German counterparts. That didn't prevent the dollar's steep fall after 1985.

The fact is, interest-rate differentials must compete with two other major influences: relative monetary tightness, and relative strength or weakness in the current account. What boosted the dollar in 1983-85 were high interest rates in conjunction with a savage monetary squeeze. Conversely, what undermined the dollar between 1985 and 1988, despite U.S. rates that remained high by historic standards, was a prolonged period of monetary ease.



In assessing U.S. monetary policy, many people continue to confuse the Fed's rate hikes with a true monetary tightening. But in reality, monetary policy operates two different levers. The little one is the ability to raise or lower interbank interest rates. But the big lever is the ability to adjust the level of reserves in the banking system. This, of course, directly affects the amount of bank liquidity available to support an expansion in lending.

When measured by the level of free reserves (that is, reserves in excess of reserve requirements) in the system, U.S. monetary conditions remain extremely loose. This leaves the banks under extremely heavy pressure to lend out those non-interest-bearing reserves. For good reason, U.S. banks are falling over themselves in a frantic effort to lend to consumers and businesses, undercutting any restraining effect of higher interest rates.

Some Fed officials are even warning of a trend towards excessive easing of credit standards, the same sin that nearly wrecked the U.S. banking system during the late 1980s. But the Fed can't allow a true credit tightening – not without further deflating the financial bubble it created with its ludicrously low short-term interest rates. Given the vast amount of leverage inherent in the U.S. financial system, such a tightening would spell disaster, both for the United States and for the other countries in the dollar bloc.

The other main bull argument for the dollar is the assumption that the continuing world economic recovery substantially will improve the U.S. trade balance, as slower U.S. economic growth curbs the demand for imports while faster growth in both Europe and Japan sustains a rapid expansion in exports. At first sight, this assumption seems reasonable. But we see two major offsetting factors:

- The economic and currency woes of Canada and Mexico already are hitting U.S. merchandise exports. These two countries actually account for a far greater share of U.S. trade than does the recovering European economy.

- Sharply higher interest rates are pushing up payments on the existing huge pile of U.S. foreign short-term debt. By late this year, these outflows could push the U.S. balance on investment income into a $20 billion deficit, compared to a surplus of $20 billion in 1990. That's a formidable swing, essentially working against the dollar.

A new twist in the dollar bull case is the notion that the most bullish period of this cycle will come when the markets begin to sense an impending peak in U.S. short-term interest rates. Given the conventional wisdom that the dollar

should lose its lustre once interest-rate differentials peak, this seems rather contradictory. The common argument, however, is that short-term capital inflows will then be reinforced by long-term capital inflows as U.S. bonds recover in response to the economy's soft landing.

The most obvious snag is the apparent assumption that U.S. short- and long-term capital inflows will compound once the U.S. economy's slowdown comes into sight. This notion lacks the barest shred of logic. Even if the revival of the bond bull market arrives on schedule, which we doubt, it should be obvious that any inflow of portfolio capital attracted to the U.S. markets by falling rates will be offset by an outflow of short-term "hot" money seeking higher rates abroad. Such a trade off is hardly likely to favor the dollar, given the heavy U.S. dependence on hot-money flows.

From the end of 1991 through the third quarter of 1994, bank deposits and other short-term bank liabilities accounted for $177 billion, or 59%, of total U.S. net capital inflows of about $300 billion. Official flows – that is, purchases of dollars by foreign central banks – accounted for $156.4 billion. Net long-term capital flows, meanwhile, were a *negative* $33 billion, as U.S. investors poured money into international stock and bond markets. Given this U.S. addiction to hot money, we are hard pressed to see how lower short-term interest rates could be anything but a calamity for the dollar.

But to say lower short-term rates would hurt the dollar is not to say higher short-term rates necessarily would help it. As noted above, higher rates impose their own burden on the U.S. current account, by worsening the deficit on investment income. Higher rates, obviously, also would further ravage the bond and stock markets, and hasten the coming economic slowdown.

SOFT LANDING, OR SOFT LOGIC?

In our view, the overriding question for the dollar is whether the U.S. economy is in for a soft or a hard landing. In the case of a soft landing, the dollar will weaken, but in the case of a hard landing, it will plunge.

Generally speaking, the U.S. dollar tends to rise whenever the U.S. economy has been cyclically strong relative to the rest of the world, as higher U.S. interest rates accelerate capital inflows. This cyclical increase in interest rates took place during 1994. Still, the dollar failed to perform as usual, obviously because the current-account deficit rose faster than capital inflows. If not for huge dollar purchases by the world's central banks, the dollar would have collapsed.

By contrast, the dollar always tends to experience weakness whenever the U.S. business cycle loses momentum relative to the rest of the world, because as a rule this leads to a decline in capital inflows. Such a turn clearly is in the offing. What's more, the pace of the German recovery is much stronger than had been expected. With little or no "output gap" left in Germany, the markets already are discounting higher German interest rates in 1995.

At the heart of our dollar bearishness are two factors: the huge U.S. current-account deficit, and our conviction the U.S. economy is in for a hard landing, not a soft one.

The first thing to see is that the U.S. current-account deficit has deteriorated at an unprecedented pace – worsening within barely two years from a $100-billion annual rate to the present $165 billion. That's the worse performance ever.

Our key point is that a sustained current-account deficit of this size simply is impossible to finance. As we pointed out in our last letter, the U.S. deficit may seem small when compared to the huge U.S. GDP. But it is grossly out of proportion to the limited supply of surplus world savings.

While temporary surges in capital inflows may lift the dollar in the short run, the outsized U.S. current-account deficit will continue to depress it in the long run. But our view of a looming, far more serious dollar crisis has another reason: the hard landing of the U.S. economy which we expect will happen sooner or later in 1995.

Right now, U.S. financial markets are growing increasingly enthralled with the prospects for a soft landing. The Fed is widely seen as having done its job of slowing economic growth to a sustainable rate. This is expected to sharply lower inflation and inflation expectations, launching the next big bull ride in stocks and bonds.

In the consensus view, the U.S. economy will stay strong through the first half of 1995, triggering one or two further rate hikes by the Fed. But even that much additional restraint is not certain, given recent dovish comments by Fed chairman Greenspan. In any case, the economy is expected to slow during the second half to its potential growth rate of 2.5%. The one and only perceived danger is too much growth triggering too many additional rate hikes. That would increase the ultimate danger of a recession, but only later, in late 1996 or 1997.

We read many reports and articles explaining in detail why a U.S. recession is impossible at this time. Still, it is a historic fact that recessions have a habit of taking everybody by surprise. The most recent experience in this respect was in 1990, when a recession occurred even against a background of Fed easing. Between the first and fourth quarters of 1990, real U.S. GDP growth abruptly plummeted from a +3.5% annual rate to -3.2%.

During that time, one key argument for a soft landing was said to be the supposedly lean levels of U.S. business inventories. But as the recession proved and later statistics revealed, this was a mistaken assumption. In reality, inventory ratios had been near record highs during 1990, as documented in the January 1993 issue of the Survey of Current Business. We wonder about the possibilities of similar statistical miscalculations this time.

Already, the reported surge in inventories during 1994 constitutes a crucial weak link in the soft-landing scenario – along with the unsustainability of the current consumer borrowing binge. Considering that both demand components accounted for about 90% of real GDP growth in 1994, we don't see how a substantial downturn on their part could be offset by higher investment or net exports, which account for an incomparably smaller share of GDP growth.

We don't think it's worthwhile to go into greater detail about this. It's too obvious. Yet for the time being, the U.S. financial markets seem to regard any signs of a weakening economy as a pleasant surprise, as demonstrated by the recent, instant surge in stocks and bonds in response to unexpected weakness in U.S. employment and industrial-production data.

Total Real Domestic Demand

Percentage change from previous period (1995 projected)

	1992	1993	1994	1995
United States	2.5%	3.9%	4.6%	2.8%
OECD Europe	1.1%	-0.9%	1.6%	2.6%

Source: OECD

The sea-change in market sentiment will start once the economic data become consistently weaker than expected, and investors begin to worry about the effect of a recession on business profits. The crucial drawing line is between desired and undesired economic weakness.

One false hope keeping market sentiment comparatively bullish is the belief a faltering U.S. economy and U.S. dollar will be bailed out by the ongoing world economic recovery. The crucial regions in this respect are continental Europe and Japan. And in fact both are seeing faster GDP growth, even as the United States seems poised for a slowdown.

It looks like international precision work. What is overlooked, however, is that GDP growth and domestic demand growth can be very different things. The irony is that economic growth in continental Europe so far has been export-led, with lagging domestic demand. GDP growth in the United States, by contrast, has been consumption driven. This leaves scant hope for a boom in U.S. exports, even leaving aside the fact most European economies have big output gaps to draw down as growth accelerates, while the U.S. economy is pushing up against capacity constraints. The OECD data above illustrate the relative constraints on domestic demand in Europe and the United States.

These harsh facts rule out any painless, export-led adjustment in the U.S. current account. Only a severe slowdown in economic growth – a hard landing – can reign in the U.S. deficit. But while this would ease one source of pressure on the dollar, a recession also would trigger a mass flight of the short-term speculative capital that has been the main prop under the U.S. currency.

Try as we might, we cannot construct a scenario that leads to a dollar recovery in 1995. The only question in our minds is: How serious will the dollar crisis be? As in 1994, the key will be the attitudes of the world's other central banks. Once again, they will have to purchase massive quantities of dollars if a complete dollar collapse is to be avoided.

Turning back to the global picture, the question investors around the world presently face is whether the slide in bond and stock prices over the past year provides a buying opportunity, or whether it signals the end of the investment mania that started in 1982 and culminated in the early 1990s under the impact of vastly excessive U.S. monetary ease.

Our basic message, which we have conveyed in one letter after another, is that the bubble has burst. Still, there are big differences in risks among countries and currencies. In all cases, we would urge readers who have not done so to exit stocks and longer-term bonds. Other than that, we can only note that the strong currencies now are kings. The markets to shun entirely are those of the big debtor and deficit countries. Their problems will only snowball over time. In particular, if the Mexican crisis proves uncontainable, the consequences for world financial markets will be disastrous.

THE DM ADVANTAGE

In light of these trends, the hard-currency countries, especially Germany, have emerged as safe havens. Understandably, we are pleased by this vindication of our recommendations in this respect. Still, we have to wonder what we are primarily witnessing: DM strength or dollar weakness. We suspect dollar weakness predominates. Traditionally, negative surprises in U.S. economic data – not German strength – have been the catalysts for dollar declines.

It's true, though, that German economic and inflation data currently are surprising on the positive side. Skeptics about the DM are quite right when they say that reunification has tremendously strained the German economy, turning its current account from a big surplus into a sizable deficit. But Germany's economy has come a long way in just one year.

In late 1993, the public deficit seemed set to spiral beyond 7% of GDP. Inflation was the worst among the G5 industrial countries, and the economy was languishing in its sharpest post-war recession. There were numerous reports about erstwhile industrial giants that had lost their competitiveness for good and soon would be dragged down by an east German Mezzogiorno in the making. Not only that, but at the same time German exports were being squeezed by the big devaluations of many European currencies against the DM.

Fiscal and monetary policy have gone a long way to correct these imbalances. Estimates for the public-sector deficit are being revised down each month. Rebounding growth and tight fiscal policy already have brought the pan-German fiscal deficit down from about 6% of GDP in 1993 to little more than 5% in 1994. Further tax hikes and spending cuts, in conjunction with rebounding growth, should lower it to well below 4% in 1995.

Meanwhile, inflation has fallen from a mid-1993 peak of 4.2% to 2.3%. Headline CPI inflation should hover between 2.3% and 2.5% the rest of the year. Most striking – and most important for future economic growth and inflation – are Germany's record productivity gains of 8%-to-10% in the manufacturing sector during 1994. These accrue from modest wage rises and savage cost cuttings in west German industry.

All in all, we would say the west Germany economy has entered the new year with considerable growth momentum. What's more, the pattern of growth also is positive. The recovery largely has been driven by stock building, construction investment and a rising export surplus, while public and private consumption have remained subdued.

Some skeptics, however, focus on the German current account. The cumulative shortfall in the first ten months of 1994 amounted to nearly DM 50 billion, exceeding a $32 billion deficit for all of 1993. Oddly, this has happened while the German trade surplus has been soaring. Foreign net investment income emerges as the prime mover in this paradox. Since 1991, this account has turned from an annual surplus of DM 32 billion to a deficit of about DM 10 billion.

This plunge would suggest the Germans have managed to dissipate within barely two years the large nest egg of foreign capital which accrued from their current-account surpluses of the 1980s. But in Germany, the true reason is an open secret: To circumvent the new withholding tax of 30% on investment income, Germans have massively shifted financial assets to banks in Luxembourg or elsewhere abroad. It is, in short, a case of tax-induced capital flight.

In this way, German-owned assets of perhaps DM 200 billion – mostly in DM-denominated bonds – have become legally and statistically foreign owned, making them tax free. Earnings on these portfolios now are incorrectly recorded as outflows to foreigners. A truthfully reported German current account would look far better than the official one. Inevitably, this leads to further statistical distortions. On the one hand, it grossly overstates foreign purchases of German bonds. On the other, it means German consumers have far more money to spend and save than statistics suggest.

CONCLUSIONS

The bills are coming due for the years of borrowing and spending by the United States and the other big deficit countries. Hot-money flows no longer favor the dollar and the other weak currencies. Given the imbalances and distortions in world markets and economies, this easily could snowball into a generalized financial crisis.

We must stress one point: With the exception of Mexico, what we have seen so far does not reflect actual capital flight, but simply a slowing in capital flows to the big debtor countries. This alone has been sufficient to send their currencies tumbling. It couldn't be otherwise, given the permanent outflows generated by their huge current-account deficits.

The implication is obvious: True capital flight quickly would lead to total disaster for the debtor currencies. The consequences of such a collapse would be catastrophic. The current, fragile world economic recovery would crumble.

For the Fed, this should be cause for unmitigated horror. As the de facto central bank of the world, the Fed now finds itself in an impossible position. Defending the dollar with a policy of true monetary tightness would further worsen the global liquidity squeeze. Yet accommodation would only hasten the dollar's plunge. There appears to be no way out.

We can only repeat our now fashionable advice: Seek safety and liquidity in the cash and short-term bonds of the hard-currency countries, primarily Germany, Switzerland, Austria and the Netherlands.

THE RICHEBÄCHER LETTER

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